Moody's Investors Service

Global Credit Research
Rating Update
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Rating Update: **California (State of)**

MOODY'S LOWERS STATE OF CALIFORNIA GO BOND RATING TO A1 FROM Aa3; LEASE DEBT LOWERED TO A2 FROM A1; MIG1 RATING ON RANS AFFIRMED

$25.4 Billion in Debt Affected. Outlook Remains Negative

State
CA

Opinion

NEW YORK, Nov 20, 2001 -- Moody's has lowered the rating on $19.9 billion of State of California General Obligation bonds to A1 from Aa3. In addition, we have lowered the rating on $5.5 billion in lease revenue bonds from A1 to A2.

This rating action reflects Moody's expectation that the state's General Fund budget and liquidity position will weaken substantially over the next eighteen months, in light of weakness in the technology sector of the state's economy, greatly reduced state revenue projections, and the likelihood that the state will have great difficulty reaching consensus on the necessary fiscal adjustments during its upcoming budget session. The structural gap between revenues and expenditures is now projected at more than 10% of revenues in fiscal 2003, on top of a deficit and likely liquidity shortfall in fiscal 2002. Efforts to partially restore the state's liquidity through a sale of electric power revenue bonds have stalled due to serious policy disagreements within the state government, and any sale of power bonds during fiscal 2002 is now unlikely in our view.

The new rating of A1 still indicates above-average credit quality, reflecting the state's broad based and dynamic economy, which is well-positioned for long-term growth after the current period of weakness has run its course. In addition, the rating reflects the state's volatile tax revenue performance, and a moderate burden of state tax-supported debt. State general obligation bonds are secured by the state's full faith and credit pledge, and benefit from a claim on General Fund revenues that is second in priority to annually budgeted K-12 public education expenditures. The rating outlook at this point remains negative, reflecting the possibility that economic recovery could be delayed beyond the currently anticipated timeframe, further straining the state's finances.

At this time Moody's affirms its MIG1 rating for the state's $5.7 billion Revenue Anticipation Notes issued earlier this year to fund current year seasonal cashflow needs. While the state will likely be forced to seek alternate external liquidity in the event that the power revenue bond sale does not occur before June 30th, at the present time Moody's is confident the state will be able to secure the necessary liquidity to ensure the notes are retired on schedule.

STRUCTURAL BUDGET GAP PROJECTED TO REACH 10% OF REVENUES IN FISCAL 2003, ON TOP OF DEFICIT AND LIKELY LIQUIDITY SHORTFALL IN FISCAL 2002

On a budgetary basis, General Fund revenues in the current year were budgeted at $75.1 billion, $2.9 billion less than prior year actuals - marking the first time since 1994 that the state expected to post a decline in revenue collections as compared to the prior year. Despite the state's moderate revenue assumptions, through the first four months of the current fiscal year, General Fund revenues are running approximately $827 million below estimate. This revenue under-performance is due primarily to weaker than anticipated personal income and bank and corporate tax collections, which have come in 6.4% and 17.1% below estimate, respectively. Based on the current weak trend in revenue collections to date, a more pessimistic outlook for both the state and national economies, and the under-performance of the stock market in 2001, the Legislative Analyst Office (LAO) is now projecting the state will face a current year budget deficit of $4.5 billion, a deficit that could grow to $12.4 billion by the end of fiscal 2003.

The LAO forecast assumes a dramatic decline in stock options and capital gains-related income due primarily to the drop in share values of the state's high-tech companies. Over the last several years, the state has seen a dramatic increase in income related to capital gains and stock options, rising from $25 billion in 1994 to over $200 billion in 2000. At their peak, these sources accounted for more than 22% of total state General Fund revenues. As a result of this dramatic growth, stock option and capital gains-related tax collections have become a key source of revenue vulnerability for California.

In the current fiscal year, the enacted state budget anticipated these stock market-related tax revenues would total $12.5 billion, approximately 16% of total General Fund revenues. The state's stock option and capital gains revenue estimate represented a $5 billion reduction from prior year totals, and was based on its market forecast, analysis of trading volumes, holding periods, and the estimated inventory of unexercised options at large technology firms in the state. Although moderately cautious at the time the budget was enacted, this forecast now appears overly optimistic.

The forecast assumed that market indexes would be considerably higher than today's levels. And certain estimates of the total stock of unrealized capital gains in the US equity market have been significantly revised downward since the budget was passed in early July. The magnitude of the effect on state revenues is still unknown, as is the likely course of the market over the balance of the fiscal year. However, the LAO is now forecasting that stock market-related revenue collections could be approximately $5 billion below the state's budget estimate. While the LAO forecast may prove to be too pessimistic, in our view the likely shortfall will more than outstrip the state's budget reserve. Thus, the legislature will be required to make sizable budgetary adjustments to current year appropriations to accommodate this shortfall.

IN CONTRAST TO EARLY 1990'S, STATE TAKES EARLY STEPS TO ADDRESS PROJECTED DEFICIT; LEGISLATIVE CONSENSUS REGARDING BUDGET SOLUTION MAY PROVE ELUSIVE

In response to the state's weak revenue collections, the Governor ordered a hiring freeze for all state agencies, and asked state departments to come up with $150 million in immediate budgetary cuts. Last week, he released a budget reduction proposal in which he identified $2.2 billion in expenditure reductions to address the anticipated fiscal 2002 shortfall. This proposal will be submitted for legislative consideration during an Extraordinary Session to be called in January. The Administration has acknowledged that this proposal would likely serve as the first step in addressing the state's deficit that the LAO estimates will be more than twice the amount of the proposed reductions.

Last month, the Governor indicated that the projected cumulative deficit for fiscal 2002 and 2003 could range from $8 - $14 billion. The recently released LAO report estimates the 2003 imbalance at approximately $8 billion. In an effort to begin to address this projected imbalance, the Governor has issued a directive to all state agency and department heads to prepare proposals to reduce their fiscal 2003 budgets by 15%. These proposals will be a key component to the Administration's upcoming fiscal 2003 budget recommendation.

Moody's recognizes the proactive steps taken by the Administration to address the estimated shortfalls for both the current and budget fiscal years. However, we expect any budgetary reductions of this magnitude will lead to protracted legislative debate, potentially extending into next summer. And differing opinions as to the timing and strength of the economic recovery may further complicate legislative efforts to resolve this imbalance, as will the upcoming elections in 2002. If the deficit for the upcoming year reaches $8 billion as both the Administration and the LAO estimate, the state may be hard pressed to eliminate this gap solely through expenditure reductions.

PUC DELAY COMPOUNDS LIQUIDITY ISSUES

The state's current financial plan assumes that prior to June 30, 2002, the State Department of Water Resources (DWR) power bond sale will be finalized and the General Fund will be fully repaid the $6.2 billion it is owed for past power purchase advances. However, actions taken by both the State Legislature and the California Public Utility Commission (CPUC) concerning the rate agreement between DWR and the CPUC have increased the risk the state will be unable to issue these bonds prior to the end of the current fiscal year.

These actions include: the CPUC's rejection of the rate agreement as currently proposed by the DWR; and the legislature's adoption of Senate Bill18XX which could lead to protracted litigation over existing DWR power purchase contracts. The SB18XX legislation - which has not, as of yet, been forwarded to the Governor for consideration - would establish a bond set-aside payment that would have first priority of payment claim. This change could likely lead to impairment of contract litigation by the power generators. The Governor is expected to veto SB18XX. It is not known at this time whether the legislature will act to override his anticipated action. Should the veto hold, the CPUC's intentions are unclear given its reluctance to support the DWR rate agreement for the power purchase bond program as authorized in AB 1X.

If the economy were stronger, the state would have more time to consider alternative approaches to the DWR power bond program authorized under AB1X. However, given current tax revenue risks, General Fund liquidity depends heavily on receiving expected power bond proceeds no later than the last quarter of the fiscal year. Absent those proceeds, it is likely that the state will need an alternate source of liquidity, similar to the Revenue Anticipation Warrants issued in the early 1990's.

STATE ECONOMY IN THE MIDST OF SIGNIFICANT SLOWDOWN; TIMING OF RECOVERY IS UNCERTAIN

We expect California's economy to weaken less than its tax revenues, given the state's volatile revenue structure and its heavy dependence on the stock market. Nevertheless, the weakening economy still contributes to its weakening credit position. California's economy has benefited over the last several years from positive economic fundamentals including trends of above-average population and employment growth, improved business diversity, and a concentration of high-growth, knowledge-based industries. These factors helped the state post an overall employment growth rate of nearly 4% in 2000, and drove the unemployment rate down to 4.6%, a 30-year low.

However, due in part to the overall weakness of the national economy, weaker exports, and the depressed performance of its own information technology sector, the state has experienced a major slowdown in growth during 2001. During this period, monthly employment growth has declined significantly. Since January 2001, the state has generated approximately 78,000 net new jobs, well below the pace of growth posted over the last several years. Job growth over the last twelve months through September has slowed to 1.0%. The slowdown in employment can be attributed primarily to the continued contraction in the manufacturing sector, which has lost more than 63,000 jobs this year, and the dramatic slowdown in the services sector - one of the state's key economic drivers since the mid-1990's. And the state's decelerating economy has caused the state's unemployment rate to rise by nearly a full percentage point to 5.4% by the end of September.

The state's exposure to the high technology industry will continue to temper employment growth in the near term as the semiconductor and PC manufacturing industries are not expected to rebound as fast as other sectors of the economy. However, Moody's expects the state to slightly outpace the US in terms of economic growth over the near term, with some additional drag due to weakness in tourism. It is possible that the state could realize a flat or somewhat negative employment situation, but nothing like the state's deep job losses of the early 1990's recession. The current tech woes are not comparable to the military/defense/aerospace contraction of ten years ago, where California permanently lost more than 200,000 aerospace jobs alone. The state's knowledge-based industries are expected to rebound and replace the jobs lost in the high tech sector over the last twelve months, and Moody's believes the state's economy is positioned well for long-term economic growth.

Outlook

Moody's credit outlook for California's long-term debt remains negative, reflecting the possibility that national economic recovery could be delayed beyond the currently anticipated timeframe, further straining the state's finances. The state's sizable structural budget imbalance has been exacerbated by the slowing national economy in the aftermath of the September terrorist attacks, and there is great risk that the state's budget reserve and most of its other liquid resources will be depleted by the end of this fiscal year. Given the projected size of the structural imbalance, the state is likely to have difficulty reaching consensus on a plan to restore budgetary stability. A successful issuance of power revenue bonds would significantly restore liquidity, but it is unlikely to occur prior to the end of the fiscal year. Moody's expects the state to access alternative liquidity in the form of Revenue Anticipation Warrants similar to actions taken in the early 1990's.

Analysts

Raymond Murphy
Analyst
Public Finance Group
Moody's Investors Service

Timothy Blake
Senior Credit Officer
Public Finance Group
Moody's Investors Service

Renee Boicourt
Director
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1625